



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

OFFICE OF  
CHIEF COUNSEL

Number: **INFO 2000-0415**

Release Date: 12/29/2000

UIL: 9999.98-00

November 30, 2000

:

The Honorable Jon Kyl  
United States Senate  
Washington, D.C. 20510

Dear Senator Kyl:

I am responding to your letter dated September 5, 2000, to Charles Rossotti, Commissioner of Internal Revenue. You asked us to clarify the federal income tax treatment of certain tax credits and grants awarded by the State of Arizona to promote the use of alternative-fuel vehicles.

I am pleased to provide the following general information, based on our understanding of how the new Arizona legislation works. I hope the information below is helpful to you; however, it is advisory only and not binding on the IRS. If a taxpayer in the State of Arizona would like the IRS to analyze his or her particular facts to determine the proper treatment of these tax credits and grants, he or she can submit a written request for a private letter ruling. Revenue Procedure 2000-1, 2000-1 I.R.B. 4 (copy enclosed) contains instructions on how to request a private letter ruling.

As I understand the facts, Arizona Senate Bill 1504 provides incentives to individuals and businesses for (1) purchasing or leasing alternative fuel vehicles, (2) converting conventional fuel vehicles to alternative fuel vehicles, (3) acquiring an alternative fuel refueling apparatus, and (4) constructing or operating an alternative fuel delivery system. The incentives consist of grants administered by the Arizona Department of Commerce, as well as two types of income tax credits administered by the Arizona Department of Revenue.

To obtain any of these incentives, a taxpayer must first file an application for a grant with the Arizona Department of Commerce. If a taxpayer does not receive a grant from the Department of Commerce (because the grant fund has been depleted), the taxpayer will receive a certificate from the Department of Commerce stating that the taxpayer was eligible for a grant and that no grant monies were available. The taxpayer is then eligible for an income tax credit. At the taxpayer's option, any portion of the tax credit not used to offset state tax liability in the current taxable year may be either refunded to the taxpayer, carried back by the taxpayer to offset prior-year state tax liability, or carried forward by the taxpayer to offset future state tax liability.

You asked us to respond to the questions outlined below, which are based on the following scenario: Taxpayer X files a year 2000 Arizona income-tax return in 2001 by the due date. The tax liability is \$500, and X has an alternative-fuel credit of \$5,000, leaving an excess of \$4,500. I am assuming for purposes of answering your questions that X is using the cash receipts and disbursements method of accounting.<sup>1</sup>

**Question 1: If X elects to have the \$4,500 refunded, is it taxable as income on either the taxpayer's 2000 or 2001 federal return?**

Response: The \$4,500 is included in X's gross income in 2001. Under section 61 of the Internal Revenue Code (the Code), gross income means all income from whatever source derived, and includes income realized in any form. The concept of gross income encompasses all accessions to wealth, clearly realized, over which a taxpayer has complete control. The amount of a refundable credit that exceeds X's current tax liability is treated as a grant or benefit payment, which is gross income.

Taxpayers using the cash receipts and disbursements method of accounting generally include amounts in gross income when actually or constructively received. Thus, because X actually receives the \$4,500 refund in 2001, X recognizes the \$4,500 in 2001. Section 451 of the Code and section 1.451-1(a) of the Income Tax Regulations.

**Question 2: Does the \$500 that was applied to the 2000 liability constitute taxable income for 2001?**

Response: No. The portion of a state income tax credit that reduces a taxpayer's tax liability generally is not included in gross income. Thus, the \$500 used by X to reduce his 2000 Arizona state tax liability is not included in gross income, no matter what happens to the remaining \$4,500 of the credit. However, X cannot claim the normal \$500 deduction for state income taxes paid in 2001 on his 2001 federal tax return.<sup>2</sup>

---

<sup>1</sup> The vast majority of all individuals use the cash method of accounting for tax purposes.

<sup>2</sup> Normally, a taxpayer who itemizes instead of using the standard deduction may claim a deduction for state and local income taxes paid. In this situation, X is not entitled to deduct those taxes in the following year, because he did not "pay" the \$500 to Arizona.

**Question 3: If X elects to use the \$4,500 as a carryover, applies \$2,500 to prior-year tax liabilities, and applies the remaining \$2,000 in subsequent years, in what year(s) and how much taxable income is realized?**

Response: For the same reasons discussed in our response to Question 1, the \$4,500 is included in X's gross income in 2001.

Income is constructively received by a cash method taxpayer when:

- The taxpayer has control over it
- The taxpayer is free to enjoy it at his own option
- The income exists and is available to the taxpayer, and
- The taxpayer can immediately take possession of the income

Under the doctrine of constructive receipt, the portion of the refundable credit not used by X for his 2000 tax liability (\$4,500) is constructively received in 2001, even if he chooses to use it to offset his previous and future tax liabilities. In this case, X has control over the \$4,500; he can take immediate possession by requesting a refund; or he can choose to leave it "on account" to offset his past and future tax liabilities. Thus, X recognizes the \$4,500 as gross income in 2001.

**Question 4: What effect does the credit have on X's basis in the vehicle, apparatus, or system?**

Response: The refundable tax credits provided by the Arizona alternative-fuel program would probably not have any effect on a taxpayer's basis in the vehicle, apparatus, or system for federal tax purposes because they do not appear to be refunds or rebates of amounts originally paid to the State of Arizona.

Generally, the basis of property is equal to its cost. Section 1012 of the Code. However, a taxpayer must adjust basis to reflect "expenditures, receipts, losses, or other items" properly chargeable to capital account. When a taxpayer receives a refund or rebate of all or part of an expenditure that was capitalized as part of the basis of property, he or she must adjust the basis of the property downward to reflect that fact if the person making the refund or recovery is the person who originally received payment for the item or expenditure. Section 1016 of the Code. Here, the person making the refund (the State of Arizona) is probably not the person who originally received payment for the vehicle, apparatus, or system.

However, we cannot reach a definite conclusion on this issue based on the facts provided. For example, to the extent a grant or credit represents a refund of a state tax or fee that was paid and properly capitalized as part of the basis of the

item in question, X might be required to make a downward adjustment to his basis.

**Question 5: What reporting form does the State of Arizona use to report this income (if indeed it is taxable income) to the Internal Revenue Service and the taxpayer?**

Response: The State of Arizona should use a Form 1099-G to report taxable income resulting from the award of a refundable credit (\$4,500 in the case of X) to the IRS. The state must also send a written statement to each taxpayer receiving a refundable credit, which includes the name of the state granting the credit, the amount of the credit, the taxable year the refund was made, and a statement that the amount of the credit is being reported to the IRS. Section 6050E(b) of the Code. The state can fulfill this requirement by sending a copy of the Form 1099-G to the taxpayer, with a note that the amount of the credit is being reported to the IRS.

I hope this information is helpful to you. If I can be of further help, please contact me at (202) 622-4800 or [REDACTED] of my office at (202) 622-4950.

Sincerely,

Heather C. Maloy  
Associate Chief Counsel  
(Income Tax & Accounting)

Enclosure